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No. 07-1526

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In the Supreme Court of the United States

CEMCO INVESTORS, LLC, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that 26 C.F.R. 1.752-6 applies retroactively to petitioners' transactions.

2. Whether the court of appeals correctly rejected petitioners' argument that 26 U.S.C. 6662, which provides for penalties when a taxpayer misstates "the value of any property (or the adjusted basis of any property)" by more than a certain percentage, applies to a misstatement of basis only if a misstatement of value is "embedded" in that misstatement of basis.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-10) is reported at 515 F.3d 749. The opinion of the district court (Pet. App. 11-35) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 7, 2008. On April 4, 2008, Justice Stevens extended the time within which to file a petition for a writ of certiorari to and including June 6, 2008, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On August 13, 2000, the Internal Revenue Service (IRS) issued Notice 2000-44, 2000-2 C.B. 255, which alerted taxpayers that certain transactions designed to

create artificially high bases in partnership interests in order to manufacture artificial losses were ineffective for federal tax purposes. Pet. App. 20. The notice stated that losses claimed based on those transactions could be challenged under, *inter alia*, 26 U.S.C. 752, which addresses the proper treatment of liabilities by partners and partnerships. Pet. App. 22. The notice also stated that taxpayers who claim losses based on the transactions could be subject to accuracy-related penalties under 26 U.S.C. 6662, including penalties for misstating the value or adjusted basis of property. Pet. App. 22.[1]

More than three months later, Paul M. Daugerdas, a tax lawyer whose promotion of basis-inflating tax shelters of the sort described in Notice 2000-44 led to the demise of Jenkens & Gilchrist, P.C., implemented one of those shelters for the benefit of himself and a client. Pet. App. 2, 13-15. Daugerdas utilized three entities for the shelter (in addition to a wholly-owned entity through which he held his share of the other three entities): Cemco Investors, LLC (Cemco), Cemco Investment Partners (the Partnership), and Cemco Investors Trust (the Trust). *Id.* at 13.

On December 4, 2000, the Trust purported to pay Deutsche Bank (the Bank) a premium of $3.6 million for the right to receive $7.2 million from the Bank if the dollar-to-euro exchange rate was less than or equal to $.8652 per euro on December 19, 2000; simultaneously, the Bank purported to pay the Trust a premium of $3.564 million for the right to receive $7.128 million from

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[1] Unless otherwise indicated, all references in this brief to the relevant statutory provisions are to the 2000 edition of the United States Code. Although there have been some changes to the provisions since that time, they do not affect the legal analysis of the case.

the Trust if the dollar-to-euro exchange rate was less than or equal to $.8650 per euro on that date. Pet. App. 2-3, 14. The offsetting premium "payments" for the option contracts were effected by a transfer from the Trust to the Bank of $36,000 (the difference between $3.6 million and $3.564 million). *Id.* at 3. The Bank promised to refund $30,000 of that $36,000 if the option contracts offset each other on the exercise date. *Ibid.* On December 5, 2000, the Trust assigned its contractual right to the Partnership, which in turn assumed the Trust's corresponding contractual obligation. *Id.* at 14-15.

On December 18, 2000, the Partnership purchased just under 56,000 euros for $50,000. Pet. App. 3, 15. The next day, the option contracts offset each other, and the Bank refunded $30,000 to the Partnership. *Ibid.* The Partnership liquidated two days later, distributing the euros and some leftover cash to the Trust. *Ibid.*

On December 26, 2000, the Trust transferred the euros to Cemco. Pet. App. 15. Three days later, Cemco sold the euros for approximately $51,325. *Ibid.* Cemco reported a loss of approximately $3,563,212 from this sale on its 2000 tax return, even though the Partnership had purchased the euros for only $50,000 eleven days before Cemco sold them for $51,325. *Ibid.* The claimed loss is based on the theory that, in determining the Trust's basis in the Partnership (its outside basis), the payment side of the transactions must be taken into account, while the offsetting obligation side must be ignored because of its allegedly contingent nature. *Id.* at 15-16, 23. Thus, the Trust claimed an aggregate basis in the Partnership of approximately $3.6 million for an investment of only $36,000. That disconnect ultimately led to Cemco's claimed loss of approximately $3,563,212 on

the sale of the euros, even though the out-of-pocket costs of its principals were approximately $6000.[2]

The IRS disallowed the claimed loss on various grounds, including that, under Section 752 and its implementing regulations, the obligation side of the transactions had to be treated as a liability that reduced the Trust's outside basis in the Partnership. See Pet. App. 17; Pet. C.A. App. A62. The IRS also determined that Cemco's underpayment of tax was subject to penalties under Section 6662, including the 40% penalty for egregious misstatements of value or basis (gross valuation misstatements). *Id.* at A62-A63; see 26 U.S.C. 6662(h).

2. Petitioners sought review of the IRS's determinations in the United States District Court for the Northern District of Illinois. Pet. App. 12. The district court granted summary judgment in favor of the United States. *Id.* at 11-35.

The district court held that Cemco's claimed loss was precluded by 26 C.F.R. 1.752-6. Pet. App. 20-31. That regulation was promulgated, initially in temporary form, on June 24. 2003, to implement the IRS's position, expressed in Notice 2000-44, that losses generated by tax shelters like the one utilized by petitioners are inconsistent with Section 752. *Id.* at 5-6, 22. The district court explained that the regulation makes clear that, when, in connection with a partner's contribution of property to a partnership, the partnership assumes the partner's obligation to make a payment, whether fixed or contingent, that obligation must be reflected as a reduction in

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[2] The purchase and sale of the euros was a necessary part of the scheme because, under 26 U.S.C. 732(b), a partner's outside basis attaches to any property distributed to him in kind in liquidation of his interest. The euros served as "property" to which the Trust's inflated outside basis in the Partnership could attach.

the partner's outside basis. See *id.* at 22-23. The court further noted that the regulation by its terms applies to transactions, such as petitioners', which occurred between October 19, 1999, and June 23, 2003. See *ibid.* (citing 26 C.F.R. 1.752-6(d)).[3]

Petitioners acknowledged that the regulation disallowed losses of the type that Cemco claimed, Pet. App. 23, and they did not argue that the regulation could not be applied retroactively to the transactions at issue, see *id.* at 25 & n.6. Instead, petitioners argued that the IRS could not disallow Cemco's claimed loss because the IRS could adjust the basis of the euros only by issuing a notice of adjustment to the Partnership, and, absent such a notice, Cemco was required to use the basis assigned to the euros by the Partnership. See *id.* at 24-31. The district court rejected those arguments. See *ibid.*

The district court also rejected petitioners' challenge to the valuation misstatement penalties. Pet. App. 31-35. Section 6662 provides for penalties when an underpayment of tax is "attributable to," among other things, a "substantial valuation misstatement" or a "gross valuation misstatement[]." 26 U.S.C. 6662(b) and (h). As the district court explained, "a substantial valuation misstatement occurs when 'the value of any property (or the adjusted basis of any property) claimed on any return of tax . . . is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).'" Pet. App. 32 (quoting 26 U.S.C. 6662(e)(1)(A)). The definition of "gross valuation misstatement," the court further explained, is the same, except that the penalty is increased to 40%

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[3] A much more detailed set of rules applies to transactions occurring on or after June 24, 2003. See 26 C.F.R. 1.752-7.

and the amount claimed on the tax return must be 400% or more of the correct value or adjusted basis. *Ibid.*

Petitioners argued that "a misstatement of 'adjusted basis' should be punishable under section 6662 only if a misstatement of value 'is embedded in [the] misstatement of adjusted basis.'" Pet. App. 33 (quoting Pet. Br. in Supp. of Mot. for Partial Summ. J. 15). According to petitioners, that interpretation of the statute was required because of the parentheses around the phrase "or the adjusted basis of any property" in Section 6662(e)(1)(A). See *ibid.* The district court rejected petitioner's interpretation as contrary to "the clear statutory language." *Ibid.* The court observed that, "[w]hile Cemco makes a valiant effort to overcome the language of section 6662, it has included nothing in its briefs to indicate that an interpretation such as it describes was intended." *Id.* at 33-34.

3. The court of appeals affirmed the district court's judgment. Pet. App. 1-10. After describing the transactions that petitioners had used to generate their claimed loss (*id.* at 1-4), and noting that "[t]he deal as a whole seems to lack economic substance" (*id.* at 4), the court considered and rejected petitioners' argument that Section 1.752-6 may not be applied retroactively to their transactions. *Id.* at 5-8. The court explained that "[t]he regulation could not be more explicit" that it "applies to assumptions of liabilities," like petitioners', "occurring after October 18, 1999, and before June 24, 2003." *Id.* at 6 (quoting 26 C.F.R. 1.752-6(d)(1)). The court acknowledged that, under 26 U.S.C. 7805(b)(1), IRS regulations "generally do not apply to transactions" that predate publication of the regulations. Pet. App. 6. The court noted, however, that, under the plain terms of Section 7805(b)(6), "the norm of prospective application 'may be

superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation.'" *Id.* at 6-7 (quoting 26 U.S.C. 7805(b)(6)). The Court further explained that Congress had authorized the Secretary to prescribe an effective date for the regulation in this case in Section 309 of the Community Renewal Tax Relief Act of 2000 (2000 Act), Pub. L. No. 106-554, 114 Stat. 2763A-638. Pet. App. 7. That statute, the court explained, enacted basis-reduction rules for many transactions and authorized the IRS to adopt regulations prescribing similar rules for partnerships and to make those regulations retroactive to October 18, 1999. See *ibid.*

The court of appeals stated that one district court, in *Klamath Strategic Inv. Fund, LLC* v. *United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006), appeal pending, No. 07-40861 (5th Cir. filed Sept. 7, 2007), had concluded that the retroactivity of Section 1.752-6 cannot rest on the 2000 Act because the IRS had not availed itself of that authority in promulgating the regulation. Pet. App. 7. The court of appeals concluded, however, that the IRS had clearly relied on the authority provided by the 2000 Act because the IRS had chosen October 18, 1999, as the effective date for the regulation. *Ibid.*

The court therefore held that Section "1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss." Pet. App. 7. The court observed that "Cemco is scarcely in a position to complain—not only because this tax shelter was constructed after the warning in Notice 2000-44, but also because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." *Id.* at 7-8.

The court of appeals also rejected petitioners' renewed arguments that the IRS could not disallow Cemco's claimed loss because the IRS could adjust the basis of the euros only by issuing a notice of adjustment to the Partnership, and, absent such a notice, Cemco was required to use the basis assigned to the euros by the Partnership. Pet. App. 8-10. Petitioners also renewed their argument that "a misstatement of adjusted basis is not within the scope of the penalty" provisions of Section 6662 "unless a misstatement of valuation is embedded in that misstatement of adjusted basis." Pet. C.A. Br. 38. The court of appeals rejected that argument without addressing it in the opinion.

ARGUMENT

Petitioners contend that this Court's review is warranted because, "[t]hrough its decision below, the Seventh Circuit entered both a three-way circuit split on the meaning of the economic substance doctrine and a two-way split on the meaning of the valuation-misstatement penalty statute." Pet. 11. Contrary to that contention, the court of appeals did not take a position on either of the circuit conflicts identified by petitioners. Instead, the decision below rested on other grounds, which the court of appeals decided correctly and which petitioners have not challenged in their petition for a writ of certiorari. Accordingly, this Court's review is not warranted.

1. a. Petitioners err in contending that "the Seventh Circuit subtly adopted a view of the [economic substance] doctrine that conflicts with the holdings of at least five other circuits." Pet. 12. On the contrary, neither the district court nor the court of appeals rested its judgment on the economic substance doctrine, the application of which entails a fact-laden inquiry. Instead, the

district court held that Cemco's claimed loss was precluded by Section 1.752-6, a mechanical basis-reduction rule that obviates the need for any factual inquiry into the subject transactions' economic substance. Pet. App. 20-25. The court of appeals agreed, rejecting petitioners' argument that the regulation could not validly be applied retroactively to petitioners' transactions. *Id.* at 5-7.

The court of appeals did not rest its decision on the economic substance doctrine, much less silently take sides in a disagreement about the contours of that doctrine. Petitioners' contention that it did (Pet. 11-12, 17-18) is based entirely on two isolated sentences of *dicta* in the court's opinion. Petitioners rely on the court's passing statement that "[t]he deal as a whole seems to lack economic substance." Pet. 11-12 (emphasis omitted) (quoting Pet. App. 4). But the court made that statement, which does not even take a conclusive position on whether the transactions lacked economic substance, in describing the facts of the case and before addressing the legal issues. See Pet. App. 4. Petitioners also rely on the court's statement that Section 1.752-6 merely served to "instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." Pet. 12 (quoting Pet. App. 7-8). But the court made that statement after it had already held that Section "1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss." Pet. App. 7. Because the court of appeals' decision did not rest on the economic substance doctrine, this case does not present the Court with an opportunity to resolve any disagreement among the courts of appeals in their approach to that doctrine.

b. The actual holding of the court of appeals—that Section 1.752-6 validly applies retroactively to petitioners' transactions—is correct and does not warrant review. As the court of appeals explained, Section 1.752-6 expressly states that it "applies to assumptions of liabilities," like petitioners', "occurring after October 18, 1999, and before June 24, 2003." Pet. App. 6 (quoting 26 C.F.R. 1.752-6(d)(1)). Although IRS regulations "generally do not apply to transactions" that predate publication of the regulations, see 26 U.S.C. 7805(b)(1), that limitation on retroactive application "may be superseded by a legislative grant from Congress authorizing the Secretary [of the Treasury] to prescribe the effective date with respect to any regulation," 26 U.S.C. 7805(b)(6). As the court of appeals concluded, the Secretary's decision to prescribe an effective date for Section 1.752-6 was authorized by Section 309 of the 2000 Act, 114 Stat. 2763A-638. Pet. App. 7. That statute prescribed basis-reduction rules for many transactions and authorized the IRS both to adopt regulations prescribing similar rules for partnerships and to make those regulations retroactive to October 18, 1999. See *ibid.*

Petitioners incorrectly criticize the court of appeals for failing to conduct what petitioners term a "conventional retroactivity analysis" (Pet. 12) of the kind conducted in *Snap-Drape, Inc.* v. *Commissioner*, 98 F.3d 194 (5th Cir. 1996), cert. denied, 522 U.S. 821 (1997). See Pet. 12, 21-22. The analysis in *Snap-Drape* and similar cases, dealing with retroactive regulations issued pursuant to a prior version of 26 U.S.C. 7805(b) (1994), has no application to retroactive regulations issued pursuant to Section 7805(b)(6), which was enacted in 1996.

In *Snap-Drape*, the Fifth Circuit applied a four-factor test—based largely on fairness concerns, includ-

ing whether the taxpayer had justifiably relied on prior law—in reviewing the Commissioner's promulgation of a retroactive regulation pursuant to the pre-1996 version of Section 7805(b). See 98 F.3d at 202. Under that version of Section 7805(b), the Commissioner generally was authorized to issue retroactive regulations, subject to judicial review for abuse of discretion. See, *e.g.*, *Gehl Co.* v. *Commissioner*, 795 F.2d 1324, 1332 (7th Cir. 1986). In 1996, however, Congress entirely revised the Commissioner's authority to issue retroactive regulations. See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1101(a), 110 Stat. 1468. As amended, Section 7805(b) now generally prohibits the Commissioner from issuing retroactive regulations. See 26 U.S.C. 7805(b)(1). There are, however, specific exceptions to the general prohibition against retroactivity, see 26 U.S.C. 7805(b), and, as the court of appeals correctly held (Pet. App. 6-7), the Commissioner relied on one of those exceptions here—a legislative grant of authority to prescribe a regulation's effective date, 26 U.S.C. 7805(b)(6).

When the Commissioner promulgates a retroactive regulation pursuant to a specific legislative grant of authority, that action is not subject to judicial review for abuse of discretion because it is expressly authorized by Section 7805(b)(6). Instead, a reviewing court is limited to determining whether, as a matter of law, the regulation falls within the scope of the legislative grant of authority. That is precisely the determination that the Seventh Circuit made in the decision below, and petitioners have not challenged that determination in this Court. Accordingly, the court of appeals' decision that Cemco is not entitled to its claimed loss does not warrant this Court's review.

2. Petitioners' request for review of the court of appeals' ruling affirming the penalties under Section 6662 is similarly misconceived. Petitioners incorrectly contend (Pet. 22-31) that this case presents this Court with the opportunity to resolve a disagreement among the courts of appeals over the scope of Section 6662. Contrary to that contention, the decision below does not implicate the disagreement identified by petitioners. And petitioners have not challenged the actual holding of the court of appeals on the penalty issue.

a. The disagreement among the courts of appeals identified by petitioners actually concerns the scope of 26 U.S.C. 6659 (1988), the now-repealed predecessor to Section 6662. Similar to Section 6662, that section provided for penalties for certain underpayments of tax when those tax underpayments were "attributable to" a valuation overstatement. 26 U.S.C. 6659(a) (1988) (repealed 1989). The disagreement concerns whether an underpayment of tax is "attributable to" an overstatement of value or basis in situations where deductions or credits premised on the overstated value or basis are disallowed in their entirety based on some other rule or doctrine. Compare, *e.g.*, *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988) (valuation misstatement penalty not applicable to underpayment resulting from disallowance of depreciation deductions and investment tax credits based on taxpayers' failure to place the subject assets in service during the year in issue), with *Massengill* v. *Commissioner*, 876 F.2d 616 (8th Cir. 1989) (valuation misstatement penalty applicable to underpayments resulting from disallowance of depreciation deductions and investment tax credits based on taxpayers' failure to acquire tax ownership of the subject assets under economic substance doctrine).

Even assuming that the courts that disagree over the scope of Section 6659 would have the same disagreement about the scope of Section 6662 (which also contains the phrase "attributable to"), that disagreement is not implicated by this case. Petitioners assert that, "[b]y rejecting Cemco's challenge to the valuation misstatement penalty, the Seventh Circuit implicitly sided with those courts that take a broad view" of when an underpayment is "attributable to" a misstatement of value or basis. Pet. 25. That assertion is incorrect. Petitioners never argued in the court of appeals that Cemco's understatement of tax was not "attributable to" a misstatement of value or basis because Cemco's basis in the euros was eliminated based on Section 1.752-6. Nor did petitioners' briefs in the court of appeals allude to any disagreement among the courts of appeals on the scope of the penalty provisions, much less urge the court of appeals to "t[ake] sides" in that disagreement. Pet. 22. Petitioner's sole argument on the penalty issue was that "a misstatement of adjusted basis is not within the scope of the penalty unless a misstatement of valuation is embedded in that misstatement of adjusted basis." Pet. C.A. Br. 38; see *id.* at 33-41; see Pet. C.A. Reply Br. 18-20. By rejecting that argument, the court of appeals did not express any view on the disagreement among the courts of appeals that petitioner now asks this Court to resolve. Accordingly, this case does not present an opportunity for the Court to resolve that disagreement.

Petitioners insist that the penalty issue raised in their petition for a writ of certiorari is properly presented because "Cemco argued, both before the district and circuit courts, that the IRS could not apply § 6662 against it," and "the traditional 'pressed or passed upon' rule for granting certiorari requires only that a claim be

'pressed' *or* 'passed upon,' not both." Pet. 25 (quoting *United States* v. *Williams*, 504 U.S. 36, 41 (1992)). But *Williams* articulates the "pressed or passed upon" rule in terms of issues or questions presented, not "claim[s]." Although Cemco certainly pressed below its generalized claim that "the IRS could not apply § 6662 against it," *ibid.*, it did not, as discussed above, press the issue that is the subject of the "longstanding circuit split" (*ibid.*) that petitioners now ask this Court to resolve (*i.e.*, whether an underpayment is "attributable to" an overstatement of value or basis when deductions or credits premised on the overstated value or basis are disallowed in their entirety for some other reason). That issue was neither pressed nor passed upon by the court of appeals, and it is not properly before this Court.

b. The penalty issue that the court of appeals did resolve also does not warrant this Court's review. By affirming the district court's judgment upholding the valuation misstatement penalty, the court of appeals implicitly rejected petitioners' argument that basis overstatements are subject to Section 6662 penalties only if they involve an "embedded" valuation misstatement. The court of appeals was correct to reject that argument, which, as the district court explained (Pet. App. 32-34), is contrary to Section 6662's plain text. See 26 U.S.C. 6662(e)(1)(A) (treating misstatements of "the value of any property" and misstatements of "the adjusted basis of any property" interchangeably). Indeed, the court of appeals apparently did not even consider the argument worth addressing in its opinion, and petitioners have not renewed the argument in their petition for a writ of certiorari. Accordingly, there is no reason for this Court to consider it.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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